UNITED
NATIONS

ST

Secretariat

Distr.
LIMITED

ST/SG/AC.8/1997/L.11
22 October 1997
ENGLISH
ORIGINAL: SPANISH

AD HOC GROUP OF EXPERTS ON INTERNATIONAL
COOPERATION IN TAX MATTERS
Eighth meeting
Geneva, 15-19 December 1997

TAX HAVENS: THE NEED TO NEUTRALIZE THEIR DISTORTING EFFECTS IN THE INTERNATIONAL TAX CONTEXT*

I. INTRODUCTION

The mere existence of tax havens, let alone their satisfactory definition, gives rise to varied reactions among tax experts. We should, however, confess that, for our purposes, we do not consider experts those who merely describe them and explain, with an obvious vested interest, how the tax regimes of these havens work, and how foreign individuals and foreign legal entities can take advantage of such regimes or of other forms of treatment such as those of a corporate or banking nature.

In any event, tax havens exist. It is therefore necessary to define their main features, and rather than criticizing or justifying their presence, we should look into the reason for their current existence.[1] It is also very important to minimize, and if possible, eliminate tax havens as tax-evasion mechanisms on an international level or as shelters for hiding gains from illicit activities.

II. WHAT IS THE DEFINITION OF A TAX HAVEN?

Predictably, authors have varied opinions on how a tax haven is set up and what it is.

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* Prepared by Mr. Adolfo Atchabahian, consultant to the Department of Economic and Social Affairs of the United Nations Secretariat. The views expressed are those of the author and do not necessarily reflect those of the United Nations.

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Alain Vernay[2] began his interesting book with a harsh look at tax havens. Accepting them as part of reality, he said they were where "timid as well as bold capital dreams of escaping to sooner or later. There, secrecy is secure, taxes are light and freedom absolute". The author uses an anecdotal style, full of colourful and readable touches, to tell abundant inside stories taken from current political and economic realities, which are directly or indirectly related to the tax havens examined in the book. That style, however, does not seem very useful in defining the basic features of tax havens. This is evident in the book where he says "a tax haven is always a fair ground, a free-trade zone and a currency-exchange office all lumped together; it is populated by a foreign legion of wealthy people and united essentially by customs conventions, and by a common use of financial regulations, a common parity rate and a common concept of profit".[3]

Richard Gordon's statement,[4] however, is somewhat more substantial. For him a tax haven is "any country that has a low tax rate or no taxes at all" either for all income or a given category of income, and one that also offers a certain degree of banking or trade secrecy.

Milka Casanegra de Jantscher's[5] brief and substantial analysis is more useful for our purposes. The term refugio tributario (tax shelter) used here is interchangeable with tax haven. In the author's opinion, it is a place where foreigners can receive income or acquire assets without having to pay high taxes on them.

The Executive Secretariat of the Inter-American Centre of Tax Administration (CIAT) also elaborated a definition of a tax haven, saying that it was not only a place where tax benefits were awarded or where one could take advantage of legal provisions to obtain certain tax benefits, but was also a place that possessed other, non-tax features which made the country or place a suitable centre for carrying on a diversity of businesses. The CIAT concludes this definition, however, by emphasizing the subjective aspect, saying that it referred mainly to persons or entities not resident in these places or countries.[6]

Casanegra de Jantscher says that this last circumstance is the distinctive quality of a tax haven. Obviously, it is therefore of decisive importance in terms of taxation for those countries whose residents, citizens or companies are attracted by the pull of the tax havens.

As a consequence, while there is an element of legitimacy in foreigners availing themselves of the diverse comparative advantage offered by tax havens, it is equally legitimate for these countries to be concerned about losing the income and wealth of its residents, citizens or companies to these havens; their concern stems from the desire to check this tendency, which obviously causes a loss of tax revenue and restricts the volume of funds available for development of their national economies.

III. REASONS FOR THE EXISTENCE OF TAX HAVENS

We are inclined to say that perhaps the main cause of the boom in tax havens in recent times - especially since the Second World War - has been, on the one hand, the highly unstable, disorderly, if not chaotic, development in both the political and the economic spheres, often accompanied by frenetic devaluation of their currencies by many countries, particularly developing countries, along with the steady growth, on the other hand, of informal, clandestine, hidden or underground economies in almost all countries, without any distinction as to their degree of economic development.[7]

The first category of reasons, engendered by situations of legal insecurity, sharp restrictions or even absence of guarantees in the exercise of the right of ownership, or discretionary measures of confiscation or appropriation of property, understandably leads to a search for locales which offer adequate levels of security and in which these sources of uncertainty do not exist. In these circumstances, the factors mentioned take absolute priority, and it is only after they have been provided for that, when conditions are similar in different tax havens, the decision may be influenced by tax considerations, with the aim of reducing the tax burden or of avoiding tax altogether.

As to the second category of reasons, which may originate in either licit or illicit activities, they may be motivated to some extent by tax considerations. Thus Tanzi notes in respect of the United States of America that, in comparison with the relatively small increase in the underground economy during the period 1970-1978, there is some indirect evidence indicating that after 1978 the underground economy grew more rapidly because of the sharp increase in marginal income-tax rates.[8]

In the above-mentioned observation, which clearly refers to income tax rates, there is a reason which is normally regarded in itself as a factor giving rise to the existence of tax havens, namely a level of taxation imposed by a country which its taxpayers consider high and which they therefore find it justified to reduce by diverting part of their income to countries with lower taxation.

It should be recognized that, as far as individuals are concerned, their decision to move into a tax haven may also be influenced in the event that the latter imposes no tax at all on inheritance.

In sum, any one of the reasons mentioned, or all of them together, which may take an infinite variety of forms, give rise to an inclination to abandon a certain type of politico-economic environment and look into places whose legal systems foster confidence among individuals, either at the present time or in the future, or where the tax burden is lighter.

In other words, whatever the purpose associated with them - tax, financial, corporate, etc. - tax havens do not necessarily arise spontaneously, but are more often the result of causes outside them; in reality, however, in the more orderly and stable political-economic climate which the entire world is experiencing in the current decade, and also because of the widespread trend to

reduce income-tax rates, either for individuals or for companies, we believe that tax havens are gradually losing the understandable and limited degree of justification they might have had because of various reasons explained earlier.

IV. CHARACTERISTICS AND SCOPE OF TAX HAVENS

On the basis of what we have explained, it is not really acceptable to consider tax havens in terms of a single, general and exhaustive definition that would cover all the places which might, in some degree, be regarded as such. In each case, the actual and effective circumstances of their operation need to be examined.

There are tax havens where the operations carried out "have a bona fide commercial purpose", as Casanegra de Jantscher explains,[9] and after clarifying that such operations are generally not considered inherent in a tax haven, although they take place in it, the author explains the concept as follows:

> "Some industries located in tax shelters are engaged in the production of goods for the domestic or foreign market. There are royalties which the tax shelters pay for patents which are actually used in the country. There are foreign citizens or companies which work in tax-shelter countries and although they benefit from the low tax rates in the country, they do 'real' business within its borders."

Casanegra de Jantscher continues:

> "On the other hand, many of the businesses in tax shelters are fictitious, in that little or no business is carried on in the tax shelter itself. The merchandise bought and sold by subsidiaries in the tax shelters does not usually pass through the territory of the country but goes directly from the country of origin to the country of destination. The property of the consortia established in tax shelters is generally located thousands of kilometres away; and neither the concessionaire nor the beneficiary normally resides in the tax-shelter country."

It may be said that the hypothesis described in the paragraph we have just cited - generally made possible through the operation of subsidiary or holding companies formed ad hoc with their headquarters in the tax havens - is a typical feature of international economic life. While it is true that this modus operandi may arise from other causes - either purely commercial, or involving business strategy at the global level, or even political - it is equally true that what tends to predominate in them is the objective of reducing, or avoiding, the payment of taxes, either in the country of origin of the goods which are being marketed or of the services which are being provided, or in the country of destination of such goods or services, or perhaps in both.

To the extent that the latter is the objective sought, it "is generally achieved", Casanegra de Jantscher notes,[10] "either (1) by accumulating income in the tax-shelter country at low tax rates, and later withdrawing it and investing it elsewhere in accordance with the wishes of the investors; or (2) by

artificially moving economic gains from high-tax countries to a tax-shelter country".

In this respect, we feel that it is relevant to note that the transnational corporations (as Hubert Hamaekers[11] notes, on the basis of data extracted from documentation produced by the Organisation for Economic Cooperation and Development, over 60 per cent of world trade is carried out within the network covered by these corporations) are the bodies which are most likely to operate in this manner, through utilization of the well-known mechanism of transfer pricing of the goods and services exchanged within the same economic group between the parent corporation and its subsidiaries or branches established in different countries.[12] The vulnerability of this mechanism is all the greater when the transfer prices do not correspond to the "arm's length" principle, i.e., those which, in respect of each transaction, could result from the operation of the market in relation to the goods or services being traded.

At all events, it should be made clear that it cannot possibly be maintained that tax havens are characterized only by the dichotomy described. A definition of tax havens, covering the characteristics they may have and the varying forms these characteristics may take, would be very broad. As evidence of this it may be mentioned that, in his book on this subject, one author lists 13 indicators which, according to him, are usually taken into consideration when identifying tax havens.[13]

A brief classification of tax havens, largely in terms of taxation, might be based on the following categories:[14]

(a) There is no tax on the income of companies or on dividends transferred abroad;

(b) The income-tax rates are reduced;

(c) Resident companies are exempt from the tax on income obtained abroad, so that it is especially important to distinguish it from income produced within the tax haven; this group could be subdivided into (i) countries which withhold tax at source on dividends that companies transfer abroad to persons who are not resident in the tax haven, and (ii) those which do not withhold tax on such dividends;

(d) Income tax is not applied to the profits of holding companies; in this case too a subdivision should be made into (i) countries which withhold tax at source on dividends paid by holding companies to their shareholders, and (ii) those which exempt from tax the dividends paid by holding companies to their shareholders and the interest paid out to creditors.

In our opinion, this type of classification of tax havens - drawn up solely from the standpoint of income tax, since this is the largest part of the tax burden as a whole - should not be viewed merely as an exercise in classification; rather, it should be seen as a guide for developing taxation policies which could be adopted by countries whose tax revenues are diminished by the abuse of such havens by their taxpayers, whatever their legal nature or tax status.

A comparison of legislation enacted over the last few decades has shown that many countries have sought to develop such legislation with a view to preventing the abuse of certain provisions of their tax legislation or to preventing fraud or tax evasion, in both cases by utilizing some sort of operational mechanism which takes into account the use of tax havens.[15] This situation, on the one hand, and, on the other, the new opportunities created by the current tendency towards economic integration among regional groups of countries - with the predictable result of harmonization in the various fields of taxation - raise questions about the fate in coming years of the different measures which might be taken to neutralize the distorting effects on taxation caused by tax havens.

V. TOWARDS THE NEUTRALIZATION OF TAX HAVENS

It must be clearly understood that this goal of neutralization is based essentially on unavoidable taxation principles that must be respected at both the national and international levels. One of those principles, tax equity, is related to fairness; while another is efficiency - based mainly on economic considerations - which, if not taken into account, could compromise the obligation to achieve the best allocation of resources.[16]

Tax havens, as we have very briefly defined them, have inherent characteristics which in most cases tend to nullify application of the taxation principles mentioned above, thereby undermining the tax revenues of the countries which are the source of the capital whose yield escapes fair taxation.

The goal of universality in taxation of income is therefore seriously eroded by the utilization of tax havens to escape taxation; as a result the principle of equality is not fulfilled. It is fairly simple to achieve - as pointed out by Tanzi[17] - by using a tax haven which "may provide a convenient tax address, and thus a convenient tax residence, for taxpayers who wished to reduce their tax liabilities".

Tanzi goes on to say that "this possibility will be particularly attractive for individual taxpayers from high-tax countries who would be subject to high marginal tax rates on reported incomes in their countries". This taxation manoeuvre of using the principle of an address or residence for taxation purposes - which may also be used by corporate entities - has as many possibilities as one might imagine, to such a degree that, as Tanzi concludes, "If the residence principle is fully applied, these earnings might end up escaping taxation almost completely".

In the final analysis, according to Tanzi,[18] "it is <u>not</u> the existence of the tax havens that tends to lower the world tax rate on capital income, but the tax treatment of incomes earned elsewhere and channelled to the tax havens". He goes on to say: "If source base taxation were widely used, tax havens would not have much of an effect on the tax rates unless the tax haven countries developed large production bases themselves. It is the combination of tax havens with the application of the residence principle to some incomes that has this depressing effect on the world rate of taxation on capital income."

Keeping in mind this phenomenon of the transfer of tax bases to the tax havens, Pagan and Wilkie[19] explain that the developed countries - which (as the authors themselves state) inevitably had high tax rates - when faced with the problem of preserving their tax base, have since the mid-1970s envisaged, amongst other measures, "ways to attack the growing use of tax havens", such as the provisions for counteracting both tax avoidance and tax evasion adopted in the United States, Canada, Germany, the United Kingdom, Belgium and France. Some of those provisions single out for special treatment any operations carried out via tax havens or by enterprises established in tax havens, which are sometimes named in the relevant legislation.

VI. EXCHANGE OF INFORMATION BETWEEN TAXATION AUTHORITIES

The effort to maintain the levels of tax revenue necessary for the provision of public services - which the abuse of tax havens, as we have shown, often tends to defeat - combined with the thorny problem of combating tax evasion at the international level - frequently encouraged by tax havens - have led the affected countries to make use of a special tool: the exchange of information between national taxation authorities with a view to uncovering evidence of tax evasion by taxpayers resident in one country who failed to declare in that country income or assets originating in the other country.

Virtually all examples of existing bilateral conventions for avoiding or reducing international double taxation, including that of the Andean Pact, despite having been clearly inspired by the principle of the source - and, by extension, agreements based on those conventions - contain clauses concerning the exchange of information between taxation authorities. There are also agreements in force whose sole aim is to ensure that that exchange takes place.

The European Union, for its part, as early as 1977 - when it was known as the European Economic Community - adopted a directive providing for mutual assistance by the competent authorities of the member States in the area of direct taxation,[20] the provisions of which deal with so-called indirect as well as direct taxes, which are listed by the directive, for each signatory country. The multilateral treaty aimed at avoiding double taxation on income ratified by the five Scandinavian countries (Denmark, Finland, Iceland, Norway and Sweden), in force since 1 January 1990, also contains provisions in this area.

In any case, it must be recognized that the exchange of information between the taxation authorities of countries has been fraught with obstacles; in summing up the current situation in the area, Alberto Giovannini states that there has been a "remarkable absence of cooperation among tax authorities in industrialized countries, mirrored by strategic use of bank secrecy laws to attract foreign tax evaders".[21]

A rigorously objective analysis of the exchange of information which we are discussing leads to the conclusion that it is a suitable mechanism for achieving its intended objectives. The difficulties which may aries in that context are not inherent and are not in themselves barriers to exchange. On the contrary, those difficulties are unrelated, exogenous, mostly political in nature;

however, we do not support using sovereignty as an argument for opposing progress in the use of such exchanges.

We do feel, on the other hand, that it is quite legitimate to be concerned about the need to ensure confidentiality, discretion or secrecy when processing information in the exchange mentioned above. All possible safeguards must be put into place to avoid betraying that trust during exchanges of information. It is not, however, acceptable to refuse any exchange of tax information whatsoever, on the grounds that confidentiality could be violated.

In short: what is basically required to guarantee the successful exchange of information between taxation authorities is for the countries themselves to clearly show the political will to do so. Once that has been achieved, such exchanges must be coupled - as they are to a large extent in the European Union directive mentioned above - with all the guarantees necessary to make them a careful, responsible, serious task shared by the taxation authorities of the various countries. Thus, it is necessary to ensure that such exchanges are in fact linked to the investigation of manoeuvres or behaviours which are presumed and indeed proven to be attempts to avoid taxation. The existence of such a link will be reason enough for justifying such exchanges. Were that not the case, there would be no purpose in or justification for exchanging information.

Notes

[1] Thus, we wish to dissociate ourselves from past descriptions of tax havens. A brief reference to them appears in the introduction to L. W. Watson's dissertation of 20 November 1985 presented at the seminar on international trade held in Sao Paulo, Brazil, with references to the works of R. A. Gordon, Tax havens and their use by United States taxpayers, published in 1981, and C. Doggart, Tax havens and their use, published in 1979.

[2] Alain Vernay, Los paraísos fiscales (Barcelona, Plaza y Janés, S. A., 1970), p. 13.

[3] Op. cit., p. 253.

[4] Gordon, op. cit., in footnote 1.

[5] Milka Casanegra de Jantscher, "¿Qué son los refugios tributarios?" originally published as "Finanzas y desarrollo", vol. 13, No. 1, and reproduced in the Boletín de la DGI, Buenos Aires, December 1976, p. 676.

[6] Executive Secretariat of CIAT, "Problemática general de los paraísos tributarios", a paper presented during the course on tax administration and international taxation, given in Ajijic, Mexico, 17-28 March 1980.

[7] The Underground Economy in the United States and Abroad (Lexington, Massachusetts, Lexington Books, D. C. Heath and Company, 1982), by Vito Tanzi, is a good reference source on the subject.

[8] Vito Tanzi, op. cit. in footnote 7, p. 90.

In the conclusions of a later work ("The underground economy in the United States: annual estimates for 1930-1980", International Monetary Fund, Staff Papers, June 1983), the same author puts forward the view, on the basis of applying a methodology explained in the book that in 1980 the informal economy in the United States accounted for a share of between 4.5 per cent and 6.1 per cent of the gross domestic product.

[9] Op. cit. in footnote 5, p. 676.

[10] Op. cit. in footnote 5, p. 677.

[11] Hubert Hamaekers, "Transfer pricing: history; state of the art; perspectives" (Amsterdam, International Bureau of Fiscal Documentation, mimeo, May 1997).

[12] In various parts of their paper "Transfer pricing strategy in a global economy" (Amsterdam, International Bureau of Fiscal Documentation, 1993), Jill C. Pagan and J. Scott Wilkie link the subject of transfer prices with the existence of tax havens and explain the legislative measures adopted by various countries to prevent manoeuvres which they believe may jeopardize their tax revenue.

Vito Tanzi also makes a perceptive analysis of the interrelationship between transnational corporations and transfer prices - a subject which has been given extensive and in-depth treatment in recent years - in "Globalization, tax competition and the future of tax systems", Washington, D.C., IMF Working Paper, December 1996), under the sub-heading "Taxes on enterprise income".

[13] The book by Hoyt L. Barber (Tax Havens: How to Bank, Invest and Do Business - Offshore and Tax Free (McGraw-Hill, 1993)) is a typical example of our comment in the first paragraph of this paper regarding persons who confine themselves to describing tax havens (the author identifies 45 places as tax havens) and using this information to engage in a kind of marketing.

Of the 13 indicators mentioned above (listed on p. 8 of the book) 12 are as follows: tax structure; political and economic stability; exchange control; treaties signed in tax matters; government attitude; modern laws on commercial companies; facility of procedures for the formation of companies and competitive tariffs in that respect; facility of communications and transport; professional and banking services; secrecy and confidentiality; incentives and opportunities for investment; and location of the tax haven. Barber also mentions the application of English common law and, explaining the reason for this reference on p. 12 of his book, makes his mercenary intention even clearer in saying: "English common law has a long tradition and case law history to draw upon. It is definitely the preferred choice of legal systems. Confidentiality in financial transactions is customary practice and required under common law. Americans will find this attitude refreshing."

[14] See "Paraísos fiscales: Su origin. Su justificación. ¿Su próximo exterminio?" by Teresa Gómez and Daniel Malvestiti, in Periódico Económico Tributario (Buenos Aires, La Ley, year II, No. 46, 29 September 1993), p. 2.

We feel that it is beyond the scope of this paper to consider, and therefore will not take up, the "legal modalities of operation in tax havens" described in paragraph 6 of op. cit. in footnote 6.

[15] That tendency has been observed not only at the national level, but also, as pointed out by Ben Terra and Peter Wattel (European Tax Law, Deventer, the Netherlands, Kluwer Law and Taxation Publishers, 1993, pp. 83, 186 and 231), at the supranational level within the current European Union, where various measures and draft directives in the taxation field have been aimed at facilitating member States' efforts to counteract the negative effects on their taxation revenues that might result when their taxpayers try to avail themselves of the tax advantages offered by tax havens.

[16] Ben Terra and Peter Wattel (op. cit. in footnote 15, p. 243) maintain that: "International tax avoidance and evasion lead to losses for national budgets, violate the principle of fair taxation (honest taxpayers will have to pay more) and therefore cause distortions in the conditions of competition and prevent optimal allocation of capital."

[17] Vito Tanzi, (Taxation in an Integrating World, Washington, D.C., The Brookings Institution, 1995), p. 78.

[18] Op. cit. in footnote 17, pp. 80/81.

[19] Op. cit. in footnote 12, pp. 17/18.

The authors' explanation, on pp. 233/234, of the various factors which are sources of concern when studying in depth the transfer prices adopted by transnational corporations obviously includes, among those factors, the different ways tax havens are used.

[20] The relevant text is reproduced in its entirety beginning on p. 279 of the op. cit. in footnote 15.

This question of the exchange of information - as Tanzi says on p. 82 of the op. cit. in footnote 17 - "has acquired, and will continue to acquire, fundamental and growing importance in an integrating world".

[21] Vito Tanzi, op. cit. in footnote 17, p. 82.

Tanzi himself, in the same work, when making his final observations (p. 136), extends this lack of cooperation to the tax havens: these, he says, have no interest in sharing information with the countries from which they attract capital.

Furthermore, according to Tanzi, the various limitations surrounding the exchange of information, including between countries which are not tax havens, suggest that it would be unrealistic to suppose that exchange of information could be the one, simple solution to the problem created by lack of cooperation and by the attitude of the tax havens.